Brexit remains far from over: the “slow burn” of EU-exit will stress the British economy long term

The EU-UK Trade and Cooperation Agreement represents another step in a drawn-out, phase-by-phase Brexit, according to ***Dennis Shen (Scope Ratings)****. While the UK is expected to ultimately maintain significant access to the single market, the new customs border and uncertainties around the degree of future single-market access of UK services exporters raise economic costs. In the end, an end-state like a Swiss-esque model except accelerated with respect to the cumulative negotiation horizon, and negotiated in reverse with the UK having started from fully-frictionless trade, looks possible.*

The last-minute agreement in December announcing a free-trade agreement was not a surprise compared with our expectations. The rolling over of tariff- and quota-free trade in goods was largely in line with the roll-over of existing preferential trade arrangements that the UK has pursued with other trading partners outside the EU as an intermediate step in exiting the EU customs union.

However, exit from the customs union – to be itself phased in over three stages and in full force only from 1 July 2021 in the case of imports to the UK – has nonetheless created trading friction with the EU and, as a result, has produced immediate economic losses as companies see longer delays, higher operating costs and lower productivity. This is even though grace periods granted – such as a one-year standstill on rules of origin documents – have eased the full *scale* of distress at the border.

The trade and cooperation agreement is nonetheless expected to ensure a substantive degree of continuity longer term. In part, this comes because a principle of “managed divergence” implies either party of the agreement reserves the right to retaliate in the case the other side is considered to have gained an unfair trading advantage. So, while the UK has secured greater sovereign privileges in determining its own laws, cooperation with the EU around regulation under a new “Partnership Council” and capacity for the other side to impose tariffs in the case deregulation is considered unfair are expected over time to mitigate disparities, and space out those areas of realised divergence (and resulting trading frictions) to over a longer period of time.

While December’s arrangement largely excluded services, this is consistent with the highly phased-in and drawn-out Brexit our agency has thought probable, in which divergence with the EU is achieved over successive phases after the three extensions of Article 50[1], a transition state, lately an exit from the customs union with associated grace periods, and, in the end, agreements around additional, complementary trading agreements with the EU impacting sectors excluded from December’s arrangement.

Swiss cheese (Public Domain)

Brexit remains far from over, however – and this trade agreement, while thin, was never intended as a singular settlement but rather as a first fundamental framework around which ultimately a more-extensive set of trading agreements will be arranged, together defining the long-term economic relationship. As services were hardly discussed so far with prioritisation around agreement on goods trade in the limited ten months of negotiations prior to the conclusion of the implementation period, the focus for the UK should be upon coming to supplementary agreements similar to that for trade in goods for critical services industries such as financial services.

A non-binding memorandum of understanding is sought by March 2021 around the export of financial services including those services such as euro clearing currently operating with temporary access granted to EU markets as talks continue. However, more time is likely to be required than March before Brussels grants any fuller access for select UK financial firms even after a non-binding framework were in place. In part, it is in the self-interest of European counterparties to slow walk discussions. In addition, the UK could be incentivised to loosen areas of trading regulations to offset intervening damage to the City – exemplified in the allowance of trading of Swiss shares – however, this makes a broad blanket equivalence with the EU less likely. Any agreements around financial services are expected, in addition, to be dynamic – granting equivalence and thus market access for select UK financial industries to “passport” to the single market, and vice versa, but with an understanding that such equivalence could be retracted upon any divergence in regulatory standards – mirroring the agreement in goods.

Long term, the outcome of non-regression clauses embedded in the trade agreement alongside other restrictions to divergence – like the Irish Backstop that results in any friction in trade with the EU resulting directly in frictions in trading inside the UK itself – should reduce the long-run scale of separation and ensure preferential access to the single market for UK businesses longer term – consistent with a softer form of Brexit.

This could resemble something ultimately akin to a Swiss-esque framework except accelerated with respect to the negotiation horizon given support in accelerating talks from the series of self-imposed cliff-edge Brexit deadlines since Brexit talks began, and negotiated in reverse with the UK having started from fully-frictionless trade. However, as uncertainty will remain nearly perpetual due to a near-constant risk that changes to domestic UK law could reduce access to the single market, firm relocations of activities out of the UK will continue – ensuring a steadily growing cost from a “slow-burn” Brexit, even as the cliff-edge form of abrupt Brexit disruption has been successively avoided.

Specifically, the City of London faces permanent damage in waiting for a definitive agreement on financial services in the months ahead during which select UK financial services have at least transitionally lost passporting rights, such as investment banking and securities trading on behalf of clients in those EU countries where national regulators have *not* extended grace periods to UK firms. The European Central Bank has said banks have agreed to ultimately transition EUR 1.3trn of assets to the euro area. In the end, the UK has secured a deal for the trade of goods in which it has a trading *deficit* with the EU, but unfortunately not one as comprehensive in services in which it stands to see substantive losses to its trading *surplus*.

The introduction of customs with associated rules of origin and local content requirements has, in addition, increased economic costs – especially at a time during which strains from the virus have raised the importance of just-in-time supply chains. HM Revenue & Customs estimated that post-Brexit arrangements will add GBP 7bn (0.3 per cent of GDP) of bureaucracy to trade with the EU. We estimate that impediments to investment and costs related to Brexit contingency planning had already curtailed UK output by at least 1.5 per cent of GDP entering 2020.

The UK moreover enters this new Brexit phase amid the near-simultaneous introduction of its third national COVID-19 lockdown, which will add further strain on public finances. There is upside pressure on a government debt ratio already estimated at more than 110 per cent of GDP this year, up from 85 per cent in 2019, in view of a double-dip economic contraction, additional fiscal stimulus to address economic fallout from lockdown plus the added economic and fiscal costs of Brexit – the latter which, while much more modest and more spaced out by comparison with the sudden, severe costs of the COVID crisis near term, might pose more significant longer-term economic and institutional consequences.

This post represents the views of the author and not those of the Brexit blog, nor the LSE.

[1] Scope anticipated the three extensions of Article 50 in 2019 (see (1), (2) and (3)), similar to its expectation of the UK’s ultimate exit from the European Union on 31 January 2020.

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